Report

of the

Examination of

Franklin Farmers Mutual Insurance Company

Spring Green, Wisconsin

As of December 31, 2001

TABLE OF CONTENTS

Honorable Jorge Gomez
Commissioner of Insurance
State of Wisconsin
121 East Wilson Street
Madison, Wisconsin 53702

Commissioner:

In accordance with your instructions, an examination has been performed as of December 31, 2001, of the affairs and financial condition of

Franklin Farmers Mutual Insurance Company
Spring Green, Wisconsin

and the following report thereon is respectfully submitted:

I. INTRODUCTION

The last examination of this company was made in 1998 as of December 31, 1997. The current examination covered the intervening time period ending December 31, 2001, and included a review of such subsequent transactions deemed essential to complete this examination.

The Summary of Examination Results contains elaboration on all areas of the company's operations. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The company was originally organized as a town mutual insurance company on January 16, 1877, under the provisions of the then existing Wisconsin Statutes. The original name of the company was the Franklin Spring Green and Bear Creek Farmers' Mutual Fire Insurance Company. Subsequent amendments to the company's articles and bylaws changed the company's name to that presently used.

During the period under examination, there were two amendments to the articles of incorporation and no amendments to the bylaws. At the annual meeting held on February 22, 2000, the articles of incorporation were amended to increase the territory they can service by adding Dane County. Also at the annual meeting held on February 22, 2000, the articles of incorporation were amended to decrease the members of the Board of Directors from 11 to 7 by attrition.

A review of the certificate of authority revealed that the company is currently licensed to write business in the following counties:

Adams, Columbia, Crawford, Dane, Grant, Iowa, Juneau,
Monroe, Richland, Sauk, and Vernon

The company is currently licensed to write property, including windstorm and hail, and nonproperty insurance.

A review was made of the policy and application forms currently used by the company. The company issues an approved policy with or without endorsements for terms of three years with premiums payable on the advance premium basis. Policy fees charged policyholders are retained by the company.

Business of the company is acquired through ten agents, three of whom are directors of the company. Agents are presently compensated for their services as follows:

Type of Policy	**Compensation**
All coverage types written by the company	15%

Agents are not allowed to adjust any claims. The company hires an outside adjuster who receives a salary of $2,000 per month for her services.

Policyholders may participate in the management and control of the company by attending and voting at all annual or special meetings of the members. No member may vote by proxy. The annual meeting of the company for the election of directors and special meetings of the company are held in accordance with its articles of incorporation.

Board of Directors

The board of directors consists of nine members divided into three classes. One class is elected at each annual meeting for a term of three years. Vacancies on the board may be filled by the directors for the interim to the next annual meeting when a director shall be chosen for the unexpired term.

The current board of directors consists of the following policyholders of the company:

Name	Principal Occupation	Residence	Expiry
Martin J. Richards **	Retired	Richland Center	Resigned
Harlan Sprecher	Retired Farmer	Spring Green	2003
Carol Olson	Semi-Retired Secretary/Bookkeeper For Franklin Farmers Mut. Ins. Co.	Spring Green	2003
Paul Kinney	Semi-Retired Farmer	Blue River	2003
Ted Glasbrenner *	Insurance Agent and Farmer	Boscobel	2004
Orlen E. Richards *	Insurance Agent and School Bus Driver	Richland Center	2004
Omer Menke	Semi-Retired Farmer	Highland	2005
V. Charles Gochenaur *	Insurance Agent & Investment Broker	Richland Center	2005
Susan Maxwell	Underwriter & Office Manager For Franklin Farmers Mut. Ins. Co.	Spring Green	2005

* Directors who are also agents are identified with an asterisk.

** The director was listed on the 2001 Annual Statement, but resigned from the position on March 22, 2002.

Members of the board currently receive $75.00 for each meeting attended.

Officers

Officers are elected by the board of directors from among its members and hold office for one year or until their successors are duly elected and qualified.

Officers serving at the present time are as follows:

Name	Office	2002 Salary
V. Charles Gochenaur	President	$ 8,400
Ted Glasbrenner	Vice President	$ 600
Carol Olson	Secretary	$ 2,500
Paul Kinney	Treasurer	$ 4,000
Susan Maxwell	Manager	$30,000

Committees of the Board

The company's bylaws allow for the formation of certain committees by the board of directors. The committees at the time of the examination are listed below:

Adjusting Committee
V. Charles Gochenaur, Chair
Ted Glasbrenner
Orlen Richards
Carol Olson

Rate Committee
V. Charles Gochenaur, Chair
Ted Glasbrenner
Sue Maxwell
Orlen Richards

Finance Committee
V. Charles Gochenaur, Chair
Orlen Richards
Ted Glasbrenner
Paul Kinney
Carol Olson

Growth of Company

The growth of the company during the past five years as compiled from its filed annual statements was as follows:

Year	Net Premiums Earned	Net Losses and LAE Incurred	Policies In Force	Net Income	Admitted Assets	Policyholders' Surplus
1997	$492,288	$485,422	2,345	($121,390)	$1,990,313	$1,706,938
1998	512,676	582,155	2,310	(224,848)	2,019,977	1,505,894
1999	564,210	297,670	2,414	102,116	2,040,682	1,655,972
2000	627,014	682,366	2,521	(222,823)	1,878,173	1,336,592
2001	690,167	862,846	2,739	(482,185)	1,466,577	781,091

The ratios of premiums written, gross and net, to surplus as regards policyholders during the past five years were as follows:

Year	Gross Premiums Written	Net Premiums Written	Ending Surplus	Writings Ratios Gross	Writings Ratios Net
1997	$614,359	$501,364	$1,706,938	36%	29%
1998	692,540	523,988	1,505,894	46	35
1999	782,440	604,432	1,655,972	47	37
2000	860,997	649,597	1,336,592	64	49
2001	1,027,501	730,737	781,091	132	94

For the same period, the company's operating ratios were as follows:

Year	Net Losses and LAE Incurred	Other Underwriting Expenses Incurred	Net Earned Premiums	Loss Ratio	Expense Ratio	Composite Ratio
1997	$485,422	$179,979	$492,288	99%	36%	135%
1998	582,155	200,100	512,676	114	38	152
1999	297,670	209,185	564,210	53	35	88
2000	682,366	219,163	627,014	109	34	143
2001	862,846	344,296	690,167	125	47	172

Gross and Net Premiums Written by the company increased by 67% and 46% respectively and policies in-force has increased 17% over the period under examination. The company reported net losses and underwriting losses five out of the last six years. They reported average investment income over the period under examination of $65,331. Even with the investment gains, the company experienced a decrease in surplus of $925,847 (a 54% decrease) over this same period. It was also noted that the company had a high loss and expense ratio last year due to a large number of fire claims reported at year-end.

In response to the adverse loss experience in recent years, the company began a comprehensive inspection program on both new and renewal business. The company expects that it will take approximately three years to complete the inspections of all its existing business. Additionally, the company hired an outside adjuster to assist with the claim settlement process. The costs associated with these actions increased the company's expenses significantly in 2001. As the company completes the inspections of all its existing business, these costs are expected to decline.

II. REINSURANCE

The examiners' review of the company's reinsurance portfolio revealed there is currently one ceding treaty. The treaty contained a proper insolvency clause and complied with s. Ins 13.09 (3), Wis. Adm. Code, concerning maximum wind loss. Company retentions of risk complied with s. Ins 13.06, Wis. Adm. Code.

Reinsurer:	Grinnell Mutual Reinsurance Company
Effective date:	January 1, 2002
Termination provisions:	December 31, 2002, or any subsequent December 31, by either party providing at least 90 days' advance written notice

The coverages provided under this treaty are summarized as follows:

1.	Type of contract:	Individual Occurrence of Loss:
	Lines reinsured:	Property
	Company's retention:	$100,000
	Coverage:	100% of an individual occurrence loss above the company's retention, subject to the following limits:
		$500,000 coverage for Livestock/Poultry/Horse Operations and Commercial & Public Property
		$750,000 coverage for Farm Outbuildings and Dwelling
	Reinsurance premium:	$0.0098 (monthly rate) on the Adjusted Gross Fire Risk in Force per $1,000 at the end of each month during the contract year
2.	Type of contract:	Aggregate Excess
	Lines reinsured:	Property
	Company's retention:	Annual net losses limited to the defined retention limit
	Coverage:	100% of amounts exceeding the annual statement retention limit of $840,880
	Reinsurance premium:	$0.0389 (monthly rate) on the Adjusted Gross Fire Risk in Force per $1,000 at the end of each month during the contract year
3.	Type of contract:	Facultative
	Lines reinsured and Coverage provided:	These terms are determined on a per-risk basis with limits set forth in the contract

4.	Type of contract:	Liability section
	Lines reinsured:	Personal Liability
	Company's retention:	None
	Coverage:	100%
	Reinsurance premium:	100% of premiums charged
	Ceding Commission:	20% of ceded premium

III. FINANCIAL DATA

The following financial statements were filed with the Commissioner of Insurance in the company's annual statement at December 31, 2001. Adjustments made as a result of the examination are noted at the end of this section in the area captioned "Reconciliation of Policyholders' Surplus."

Franklin Farmers Mutual Insurance Company
Statement of Assets and Liabilities
As of December 31, 2001

Assets	Ledger	Nonledger	Not Admitted	Net Admitted
Cash in Company's Office	$100	$	$	$100
Cash Deposited in Checking Account	65,841			65,841
Cash Deposited at Interest	434,800			434,800
Stocks or Mutual Fund Investments (at Market)	614,522			614,522
Real Estate (Net of Accumulated Depreciation and Encumbrances)	129,563			129,563
Premiums, Agents' Balances, and Installments Booked but Deferred and Not Yet Due	192,134			192,134
Investment Income Due or Accrued		11,740		11,740
Electronic Data Processing Equipment – Excluding Software (Cost Less Accumulated Depreciation)	10,850			10,850
Other Assets: Federal Income Tax Recoverable	7,027			7,027
Furniture and Fixtures	5,413		5,413	
TOTALS	$1,460,250	$11,740	$ 5,413	$1,466,577

Liabilities and Surplus

Net Unpaid Losses	$ 105,547
Unpaid Loss Adjustment Expenses	1,500
Commissions Payable	43,085
Fire Department Dues Payable	1,540
Borrowed Money Unpaid	100,000
Unearned Premiums	365,369
Reinsurance Payable	62,041
Other Liabilities:	
Expense Related	
Accounts Payable	3,841
Accrued Property Taxes	2,563
TOTAL LIABILITIES	685,486
Policyholders' Surplus	781,091
TOTAL	$1,466,577

Franklin Farmers Mutual Insurance Company
Statement of Operations
For the Year 2001

Net Premiums and Assessments Earned	$ 690,168
Deduct:	
Net Losses Incurred	827,537
Net Loss Adjustment Expenses Incurred	35,309
Other Underwriting Expenses Incurred	344,296
Total Losses and Expenses Incurred	1,207,142
Net Underwriting Gain (Loss)	(516,974)
Net Investment Income:	
Net Investment Income Earned	57,832
Net Realized Capital Gains	(15,405)
Total Investment Income	42,427
Other Income:	
Miscellaneous Income	1,465
Total Other Income	1,465
Net Income (Loss) Before Policyholder Dividends and Before Federal Income Taxes	(473,082)
Federal Income Taxes Incurred	9,103
Net Income (Loss)	$ (482,185)

Franklin Farmers Mutual Insurance Company
Reconciliation and Analysis of Surplus as Regards Policyholders
For the Five-Year Period Ending December 31, 2001

The following schedule is a reconciliation of surplus as regards policyholders during the period under examination as reported by the company in its filed annual statements:

	1997	**1998**	**1999**	**2000**	**2001**
Surplus, beginning of year	$1,818,789	$1,706,938	$1,521,497	$1,655,972	$1,336,592
Net income	(121,390)	(209,245)	102,116	(222,823)	(482,185)
Net unrealized capital gains or (losses)	18,440	23,921	28,640	(96,025)	(77,289)
Change in non-admitted assets	(8,901)	(117)	3,719	(532)	3,390
Other gains and (losses) in surplus:					
Prior Year Difference in Unrealized Capital Gain(Loss)					583
Surplus, end of year	$1,706,938	$1,521,497	$1,655,972	$1,336,592	$781,091

Reconciliation of Policyholders' Surplus

A reconciliation of the policyholders' surplus as reported by the company in its filed annual statement and as determined by the examination is detailed in the following schedule:

Policyholders' Surplus per December 31, 2001, Annual Statement			$781,091
Item	**Increase**	**Decrease**	
Investment Income Due & Accrued	$	$6,917	
Total	$	$6,917	
Decrease to Surplus per Examination			(6,917)
Policyholders' Surplus per Examination			$774,174

Reclassification Account	**Debit**	**Credit**
Premium in the Course of Collection	$13,412	
Premium Booked But Deferred and Not Yet Due		$13,412
Premium Booked But Deferred and Not Yet Due	$12,800	
Advanced Premium		12,800
Total	$26,212	$26,212

IV. SUMMARY OF EXAMINATION RESULTS

Compliance with Prior Examination Report Recommendations

Comments and recommendations contained in the last examination report and the action taken on them by the company are as follows:

1. Underwriting—It is recommended that the company adhere to its underwriting guideline by performing a formal inspection for new and renewal business.

   Action—The company has complied with this recommendation.

2. Underwriting—It is suggested that the company institute a reporting system to monitor compliance with its formal inspection procedure and ensure repair or correction of hazard conditions noted on the loss prevention report.

   Action—The company has complied with this recommendation.

3. Underwriting—It is recommended, for purpose of good underwriting, that the company insist that applications for insurance are fully completed by agents and applicants prior to acceptance of risk.

   Action—The company has complied with this recommendation.

4. EDP Environment—It is recommended that the company institute a password system to prevent unauthorized access to its computers.

   Action—The company has complied with this recommendation.

5. EDP Environment—It is recommended that the company establish a procedure in which the backed-up data is kept in a safe place separate from the location where the computer is kept.

   Action—The company has complied with this recommendation.

6. Disaster Recovery Plan—It is recommended that the company develop a disaster recovery plan.

   Action—The company has not complied with this recommendation, see comments in the summary of current examination results.

7. Financial Reporting—It is recommended that the company correct errors and omissions noted in the 1997 annual statement for subsequent period filings.

   Action—The company has complied with this recommendation.

8. Stocks and Mutual Fund Investment—It is recommended that the company divest of its unrated mutual fund to be in compliance with Ins 6.20(6)(d) 3. c and 5, Wis. Adm. Code.

   Action—The company has complied with this recommendation.

9. Stocks and Mutual Fund Investment—It is recommended that the company divest a portion of its investment in a family of mutual funds to be under the 10% limit and therefore in compliance with s. Ins 6.20(6)(d) 3. c, Wis. Adm. Code.

   Action—The company has not complied with this recommendation, see comments in the summary of current examination results.

10. Stocks and Mutual Fund Investment—It is recommended that the company reduce its investment in bond mutual funds to less than the 25% limit and therefore in compliance with s. Ins 6.20(6)(d) 5, Wis. Adm. Code.

    Action—The company has complied with this recommendation.

11. Stocks and Mutual Fund Investment—It is recommended that the company's board of directors adopt and file a written investment plan with the Office of the Commissioner of Insurance in accordance with s. Ins 6.20(6)(h) 1, Wis. Adm. Code.

    Action—The company has not complied with this recommendation, see comments in the summary of current examination results.

12. Net Unpaid Losses—It is recommended that the company include in gross losses all losses paid on policies written by the company whether paid directly or by the reinsurer on the company's behalf, in accordance with the Town Mutual Annual Statement Instructions.

    Action—The company has complied with this recommendation.

13. Net Unpaid Losses—It is again recommended that the company record an estimated loss amount in its loss claims registers pursuant to s. Ins 13.05(3)(f), Wis. Adm. Code.

    Action—The company has complied with this recommendation.

Current Examination Results

Corporate Records

The minutes of the annual meetings of policyholders, meetings of the board of directors, and any board appointed committees thereof, were reviewed for the period under examination and also for the subsequent current period. The examination noted that two out of the four annual meeting minutes reviewed did not have the attendance of the meeting included. It is important that the company document the number of voting members that attend their annual meetings. It is recommended that the company maintains and records attendance of voting members at all annual meetings in accordance to s. 611.51(9), Wis. Stat.

Biographical data relating to company officers and directors have not been reported in accordance with the provisions of s. Ins 6.52, Wis. Adm. Code. The company did not file biographical sketches, for two of their nine directors, with the Office of the Commissioner of Insurance. It is recommended that the company submit all directors' biographical sketches with the Office of the Commissioner of Insurance in accordance with s. 611.54(1)(a), Wis. Stat.

The company has executed formal written agreements with all its agents. The contracts include language indicating the agent will represent the company's interests "in good faith."

Conflict of Interest

In accordance with a directive of the Commissioner of Insurance, each company is required to establish a procedure for the disclosure to its board of directors any material interest or affiliation on the part of its officers, directors, or key employees which conflicts or is likely to conflict with the official duties of such person. A part of this procedure is the annual completion of a conflict of interest questionnaire by the appropriate persons. The company has adopted such a procedure for disclosing potential conflicts of interest. Conflict of interest questionnaires were reviewed for the period under examination with no apparent conflicts being noted.

Fidelity Bond and Other Insurance

The company is afforded coverage under the terms of the following bonds or contracts and has complied with s. Ins 13.05 (6), Wis. Adm. Code, which sets forth the minimum requirements for fidelity bond coverage:

1) Fidelity and Deposit Company of Maryland (4/1/02 to 4/1/03)

   a) Fidelity Bond
   i) Insured – Franklin Farmers Mutual Insurance Company
   ii) Single loss limit: $250,000
   iii) $2,500 deductible

2) Grinnell Mutual Reinsurance Company (3/10/02 to 3/10/03)

   a) Property Coverage
   i) Commercial Building: $174,357
   ii) Commercial Contents: $50,000
   iii) $250 deductible

   b) General Commercial Liability Coverage
   i) Business Liability: $1,000,000
   ii) Medical Expenses: $5,000 per person
   iii) Fire Legal Liability $50,000 any one fire or explosion

   c) Workers Compensation
   i) Meets statutory requirements

3) NAMIC Insurance Company Inc. (3/8/02 to 3/8/03)
   a) Professional Liability
   i) $3,000,000 limit per claim
   ii) $3,000,000 aggregate limit
   iii) $5,000 deductible

   b) Directors and Officers Liability
   i) $3,000,000 limit per claim
   ii) $3,000,000 aggregate limit
   iii) $5,000 deductible

   c) Maximum aggregate limit for all coverage
   i) $3,000,000 per policy period

4) Errors & Omissions Coverage for agents of Franklin Farmers Mutual Insurance Company

   a) The company requires its agents to obtain their own adequate E&O coverage. Only eight of the company's ten agents had a copy of their E&O deck page on file with the company. A recommendation is noted on the section of this report labeled "Agents."

Underwriting

The company has a written underwriting guide. The guide covers all the lines of business that the company is presently writing.

The company has a formal inspection procedure for both new and renewal business. The agents are allowed to do an initial inspection/evaluation of property that is being newly written or renewed as part of their base commission rate that they are paid. The company hires outside inspectors to value all property for new applications and renewal business to ensure proper valuation of the properties. The outside inspectors are compensated for their services at a rate of $15.00 per hour, $0.365 per mile, and are reimbursed for other expenses related to the inspections.

Agents

The company is to submit listing information with the Office of the Commissioner of Insurance for all agents that write business for the company in accordance with s. 628.11, Wis. Stats. The examination noted that four agents listed as writing business for the company on the company's computer system and loss ratio report who were not recorded on the company's Registered Agent List provided with the Office of the Commissioner of Insurance. It is recommended that the company submit an application with the Office of the Commissioner of Insurance for all the company's agent appointments in accordance with s. 628.11, Wis. Stats.

The company requires its agents to obtain their own adequate E&O coverage. It is the company's policy that the agents send in documentation of the agent's E&O coverage to have on file at the office. However, after reviewing the E&O deck pages that were filed at the company's office, it was noted that a few of them were missing. It is recommended that the company obtain and retain a copy of all their agents' current Errors & Omissions documentation on an annual basis to provide assurance that company agents have adequate E&O coverage.

The company has reported poor underwriting results four out of the past five years. The examination noted that agents are not critically evaluated for the business they are writing and the use of individual agents' loss ratios is non existent. Furthermore, information obtained from the inspections that are done is not being complied in a fashion that allows for the evaluation of agent writing the policy. Evaluating an agent's performance may aid in identifying underwriting problem areas by agent and is necessary when actively managing a company. It is recommended that the company utilize their system generated loss ratio reports, by agent, as well as inspection results to aid in evaluating an agent's performance on an annual basis.

Claims Adjusting

The company has an adjusting committee consisting of at least three directors as required by s. 612.13 (4), Wis. Stat. The function of this committee is to adjust and supervise the adjustment of losses. As stated earlier, the company hires an outside adjuster to adjust all the claims. The adjusting committee takes into account the outside adjusters findings. The outside adjuster gives the committee a range for each claim that has been adjusted so that they can make an educated decision. The examination noted that the adjusting committee usually paid claims that fell within the mid-point of the range the outside adjuster submits.

Accounts and Records

The examiners' review of the company's records indicated that the company is in compliance with s. Ins 13.05, Wis. Adm. Code, which sets forth the minimum standards for the handling of cash and recording of cash transactions by town mutual insurance companies. The examiners noted the following:

1. A proper policy register is maintained
2. A proper cash receipts journal is maintained
3. A proper cash disbursements journal is maintained
4. A proper general journal is maintained
5. A proper general ledger is maintained

An extensive review was made of income and disbursement items. Cash receipts were traced from source records and the proper recording and eventual deposit thereof ascertained. Negotiated checks issued during the period under examination were reviewed, test checked for proper endorsement, and traced to cash records. The verification of assets and determination of liabilities were made as of December 31, 2001.

The examination noted that the company's Secretary performs the accounting function, reconciles bank accounts, and has check authorization. She also has access to open mail, handle cash receipts and make deposits in a bank. It is a sound accounting control to segregate the duties of writing checks and handling of cash from those of performing accounting functions and reconciling month-end bank balances. Furthermore, the company has adequate staffing to better segregate the cash handling function. Therefore, it is recommended that the company properly segregate the duties of signing checks and handling of cash from those of performing accounting functions and reconciling month-end bank balances in accordance with s. Ins. 13.05(4), Wis. Adm. Code.

The examination also noted the company has three people authorized to sign checks: the Treasurer, the Secretary, and the Manager. The Treasurer is the only one of the three who does not have access to the accounting records, cash receipts and petty cash fund. Examiners noted that the Treasurer pre-signed a number of blank checks just in case one of the other two officers are absent for the day and a payment had to be made. The pre-signing of checks is a poor cash procedure and it should not be done. It is recommended that the company discontinue the practice of pre-signing blank checks.

The company is audited annually by an outside public accounting firm.

EDP Environment

Company personnel were interviewed with respect to the company's Electronic Data Processing environment. Access to the computers are limited to people authorized to use the computer through the use of a password system.

Company personnel back up the computers daily and the backed-up data is kept off-site. However, the company was unable to effectively extract information from the computer files to produce a hard or electronic copy of year-end reports (such as a detailed deferred premium report and a complete unpaid loss report). Section Ins 6.80, Wis. Adm. Code requires the company to retain records of its operations and other financial records reasonably related to insurance operations since the last OCI examination. If the company retained its year-end backed-up data, it would have been possible to recreate these reports. It is recommended that the company retain its year-end backed-up data for all years since the last OCI examination, pursuant to s. Ins 6.80, Wis. Adm. Code.

A manual which describes how to use the company's software and outlines the steps to complete specific tasks assists in the continuity of operations for seldom-used applications, training, or when staff turnover occurs. The company does not maintain manuals documenting the use of its software. It is recommended that the company develop or obtain manuals documenting the use of its software applications and document its computer system technology.

Disaster Recovery Plan

A disaster recovery plan identifies steps to be performed in case the company loses a key employee, is not able to access its computer, information on its computer was lost, or the office building was destroyed, to name a few contingencies. The company personnel appear to know what needs to be done in an emergency situation, but the company has not developed a formal written disaster recovery plan, as recommended in the prior examination report. Therefore, it is again recommended that the company develop a written disaster recovery plan.

Invested Assets

Section 610.23, Wis. Stat., requires insurers to hold all investments and deposits of its funds in its own name except that:

> (1) Securities kept under a custodial agreement or trust arrangement with a bank or banking and trust company may be issued in the name of a nominee of the bank or banking and trust company; and
>
> (2) Any insurer may acquire and hold securities in bearer form.

For securities not held under a custodial agreement or trust arrangement with a bank or banking and trust company, s. Ins 13.05 (4), Wis. Adm. Code, requires that:

> Non-negotiable evidences of company investments such as registered bonds, certificates of deposits, notes, etc., shall be maintained in a safe or vault with adequate safety controls or in a safety deposit box in a bank. Negotiable evidences of company investments shall be maintained in a safety deposit box in a bank. Access to a company safety deposit box containing negotiable securities shall require the presence and signature of at least 2 officers, directors or employees of the company.

The company is in compliance with these requirements.

Investment Rule Compliance

The investment rule for town mutuals allows a company to invest in common stocks, common stock mutual funds, and other higher risk investments (referred to as “Type 2”) provided that the town mutual has a sufficient amount of lower risk investments (referred to as “Type 1”). A town mutual may invest in Type 2 securities only if it already has sufficient Type 1 investments.

Type 1 investments must equal or exceed the greater of items 1, 2, or 3.

1.	Liabilities plus $300,000	$ 985,486
2.	Liabilities plus 33% of gross premiums written	1,024,561
3.	Liabilities plus 50% of net premiums written	1,050,855
4.	Amount required (greater of 1, 2, or 3)	1,050,855
5.	Amount of Type 1 investments as of 12/31/2001	509,897
6.	Excess or (deficiency)	($540,958)

The company does not have sufficient Type 1 investments.

The investment rule prescribes that a town mutual shall divest of any investment, which does not comply with the rule within three years of its noncompliance, unless the Commissioner permits a longer period or requires a shorter period. Currently the company has three investments, with a statement value of $45,401, which are not in compliance with the investment rule. The company's plan to bring these investments into compliance was reviewed by this office. Further comments are made under the caption "Stock and Mutual Fund Investments."

ASSETS

Cash and Invested Cash **$500,741**

The above asset is comprised of the following types of cash items:

Cash in company's office	$ 100
Cash deposited in banks-checking accounts	65,841
Cash deposited in banks at interest	434,800
Total	$500,741

Cash in the company's office at year-end represents the company's petty cash fund. A physical count was made by the examiners during the course of the examination and the balance reconciled to year-end.

Cash deposited in banks subject to the company's check and withdrawal consists of one account maintained in a local bank. Verification of checking account balances was made by obtaining confirmations directly from the depository and reconciling the amounts shown thereon to company records.

Cash deposited in banks represents the aggregate of eight deposits in six depositories. Deposits were verified by direct correspondence with the respective depositories and by an actual count and inspection of certificates and/or passbooks. Interest received during the year 2001 totaled $45,104 and was verified to company cash records. Rates of interest earned on cash deposits ranged from 5.33% to 6.93%. Accrued interest on cash deposits totaled $11,740 at year-end.

Stocks and Mutual Fund Investments $614,522

The above asset consists of the aggregate market value of stocks and mutual funds held by the company as of December 31, 2001. Stocks owned by the company are located in a fireproof filing cabinet at the company.

Stock certificates were physically examined by the examiners. Stock and mutual fund purchases and sales for the period under examination were checked to brokers' invoices and advices. The company's investment in stocks and mutual funds was not in conformance with Wisconsin Statutes and the rules of the Commissioner of Insurance as regards investments made by town mutual insurers.

Noted deviations from the statutes are as follows:

1. The company invested in Fidelity Advisors Mid-Cap Mutual Fund in 2001. Stock mutual funds are considered type 2 investments. Since the company was type 1 investment deficient at year-end 2000 and 2001, the company should not have purchased type 2 investments, such as this mutual fund, pursuant to s. Ins 6.20(6)(c), Wis. Adm. Code. It is recommended that the company divest of the Fidelity Advisors Mid-Cap Mutual Fund to be in compliance with s. Ins 6.20(6)(c), Wis. Adm. Code.
2. The company reinvested dividends provided by the IDEX Janus Growth M Mutual Fund back into the fund. Any proceeds from their type 2 investments should be invested in type 1 investments until the company becomes type 1 sufficient to be in compliance with s. Ins 6.20(6)(c), Wis. Adm. Code. It is recommended, pursuant to s. Ins 6.20(6)(c), Wis. Adm. Code, that the company refrain from

investing in any type 2 assets, including reinvesting any proceeds produced from its type 2 investments until the company has sufficient type 1 assets.

3. The company invested 11.7% of its assets in Franklin High Yield Mutual Fund and 11.4% of its assets in Delaware National Highway Money Market Fund, exceeding the 10% limit set forth in s. Ins 6.20 (6)(d) 3. c, Wis. Adm. Code. This was a recommendation in the prior examination report. Therefore, it is again recommended that the company divest a portion of its investment in a family of mutual funds to be under the 10% limit of admitted assets in compliance with s. Ins 6.20 (6)(d) 3. c, Wis. Adm. Code.
4. The company voted on an investment plan noted in the board of directors committee minutes, but a written copy of the investment plan was never produced. The company did not comply with the prior exam recommendation to adopt and file an investment plan with the Office of the Commissioner of Insurance. Therefore, it is again recommended that the company adopt and file a written investment plan with the Office of the Commissioner of Insurance in accordance with s. Ins 6.20 (6)(h) 1, Wis. Adm. Code.

Dividends received during 2001 on stocks and mutual funds amounted to $21,766 and were traced to cash receipts records.

Book Value of Real Estate **$129,563**

The above amount represents the company's investment in real estate as of December 31, 2001. The company's real estate holdings consisted of their home office building.

The required documents supporting the validity of this investment were reviewed and were in order. Adequate hazard insurance was carried on the real estate and contents as noted under the caption, "Fidelity Bond and Other Insurance." The company's investment in real estate and related items was in conformance with the s. 612.36(2), Wis. Stats. in regards to real estate investments in aggregate made by town mutual insurers not to exceed one mil on the dollar of the insurance in force. However, the company did not request permission from the Office of the Commissioner of Insurance prior to the acquisition of the real property in accordance with s. Ins

6.20(6)(d) 6, Wis. Adm. Code. Therefore, it is recommended that in the future the company request prior approval from the Office of the Commissioner of Insurance to purchase realty property in compliance with s. Ins 6.20(6)(d) 6, Wis. Adm. Code.

Real estate depreciation is calculated using the straight-line mid-month conventional method.

Deferred Premiums **$192,134**

The above ledger asset is suppose to represent the amounts due from agents or policyholders at year-end on a deferred basis. However, after examining this balance it was noted that premiums in course of collection, premiums over 90-days past due , and advance premiums were all included in the above number. Reclassifications were made to properly record the balances mentioned above and are detailed in the section labeled “Reconciliation of Policyholders’ Surplus.” It is recommended that the company report Premiums in the Course of Collection, Deferred Premiums and Advanced Premiums as separate line items in the Annual Statement in accordance with Annual Statement Instructions.

The company failed to non-admit premium balances due to the company from agents or policyholders over 90-days past due in accordance with Annual Statement Instructions. Due to the fact that the balance was immaterial, no adjustment will be made. However, it is recommended that the company non-admit all premiums receivable balances that are 90-days past due in accordance with the Annual Statement Instructions.

There was no detail listing of deferred premiums as of year-end 2001 available to directly test the accuracy of the reported deferred premium balance in the 2001 Annual Statement. Company personnel accidentally deleted the December 31, 2001 deferred premium report, the file could not be recreated, and no back-up data was kept by the company. Alternative tests were performed to ensure the accuracy of the deferred premium balance, but the year-end balance could not be directly tested. A recommendation was made concerning record retention in the section of the report labeled “EDP Environment”.

Investment Income Due and Accrued **$4,823**

Interest due and accrued on the assets of the company at December 31, 2001, related solely to Cash Deposited at Interest items.

The examiners recalculated the accrued interest income and found an overstatement by the company of $6,917. An adjustment has been made to reflect the proper value of the balance, which is noted in the report section labeled "Reconciliation of Policyholders' Surplus." It is recommended that the company correctly calculate the investment income due and accrued in accordance with Annual Statement Instructions.

Electronic Data Processing Equipment **$10,850**

This asset represents the depreciated value of electronic data processing equipment purchased in 1996 through 2001. The company properly expensed software. The most recent purchases were traced to invoices and the company's cash disbursement records.

Federal Income Tax Refund Receivable **$7,027**

This asset represents an estimate of the balance refundable at year-end for federal income taxes incurred prior to December 31, 2001.

The examiners reviewed the company's 2001 tax return and traced amounts due to cash receipts records to verify the accuracy of this asset.

Equipment, Furniture, and Supplies **$0**

This asset consists of $5,414 of the net book value of equipment and fixtures owned by the company at December 31, 2001. In accordance with annual statement requirements, this amount has been deducted as an asset not admitted.

LIABILITIES AND SURPLUS

Net Unpaid Losses **$105,547**

This liability represents losses incurred on or prior to December 31, 2001, and remaining unpaid as of that date. The examiners reviewed the company's estimate of unpaid losses at year-end and found this liability to be reasonably stated. The company reached the attachment point on its aggregate excess of loss reinsurance and thus capped its net loss liability for 2001.

The examiners' review of claim files included open claims, paid claims, claims closed without payment, and all claims which were denied during the examination period. The review indicated that claims are investigated and evaluated properly and that payments are made promptly and in accordance with policy provisions upon the submission of a proper proof of loss. In addition, the review of claims handling procedures and files revealed the following:

1. A proper loss register is maintained.
2. Claim files contained sufficient investigatory data and documentation to verify settlement payments or reserve estimates.
3. Proofs of loss were properly signed.

The company could not supply detail supporting a portion of the unpaid loss balance to the examiners. The company's labeled this balance as "unidentified unpaid losses." A recommendation was made concerning record retention in the section of this report labeled "EDP Environment".

Unpaid Loss Adjustment Expenses **$1,500**

This liability represents the company's estimate of amounts necessary to settle losses which were incurred prior to December 31, 2001, but which remained unpaid as of year-end. The methodology used by the company in establishing this liability is arbitrary. This balance has not been adjusted for a few years even though unpaid loss balances have significantly increased. The examiners tested the adequacy of the balance by calculating a Paid LAE to Paid Loss ratio and applying it to the unpaid loss balance, which resulted in an estimated unpaid LAE balance of $8,868. The method used by the company to estimate unpaid LAE is not adequate compared to the Paid LAE to Paid Loss method, which assumes that the ratio of paid LAE to paid losses should be similar to the ratio of unpaid LAE to unpaid losses. It is recommended that the company uses the paid-to-paid methodology or develop its own calculation to establish an adequate reserve for loss adjustment expenses.

Unearned Premiums **$365,369**

This liability represents the reserve established for unearned premiums in compliance with s. Ins 13.08 (3), Wis. Adm. Code. This reserve was calculated at 50% of the premium in force at December 31, 2001.

Reinsurance Payable **$62,041**

This liability consists of amounts due to the company's reinsurer at December 31, 2001, relating to transactions, which occurred on or prior to that date. Subsequent cash disbursements and reinsurance accountings verified the amount of this liability.

Fire Department Dues Payable **$1,540**

This liability represents the fire department dues payable at December 31, 2001. The examiners reviewed the company's fire department dues calculation and found this liability to be correctly calculated. The actual amount paid was verified to the cash disbursement records.

Commissions Payable **$43,085**

This liability represents commissions earned by the company’s agents but are unpaid at December 31, 2001. Agents are paid when money for the related premium is received from the policyholder. The examination determined this liability to be adequately stated.

Borrowed Money **$100,000**

This liability represents money that was loaned to the company that is unpaid at December 31, 2001. The note was reviewed and subsequent cash disbursements verified the amount of this liability.

Accounts Payable **$3,841**

This liability represents the amount the company has contributed towards their employees’ SEP IRA plan that is unpaid at December 31, 2001. The amount due was traced to subsequent disbursements and an external invoice to verify the accuracy of the balance.

Accrued Property Taxes **$2,563**

This liability represents the amount of 2001 property taxes that are unpaid at December 31, 2001. The balance includes taxes on both real property and personal property. The accrued amount was traced to 2001 property tax documents and a subsequent payment to verify the balance.

V. CONCLUSION

The examination of Franklin Farmers Mutual Insurance Company resulted in 19 recommendations, 1 adjustment to surplus of $6,917 and 2 reclassifications. The recommendations that were made relate to a variety of different topics ranging from investment violations to corporate records to the electronic data processing environment. The comments and recommendations are summarized in the subsequent section.

The company's surplus per examination of $781,091 represents a 57% decrease over the past five years. The company reported 2001 gross premiums written of $1,027,501 a 19% increase from the prior year. The company experienced underwriting losses the last two years and five out of the last six years. The Company's loss ratio for the past five years averaged 100% and its expense ratio averaged 38%. Ten-year trends show that the company has increased premium writings significantly and at the same time surplus has been declining dramatically. As of year-end 2001 the company's net premium written to surplus ratio increased to .94 to 1 from prior year's ratio of .49 to 1.

VI. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 19 - Corporate Records—It is recommended that the company maintains and records attendance at all annual meetings in accordance to s. 611.51(9), Wis. Stat.

2. Page 19 - Corporate Records—It is recommended that the company submit all directors' biographical sketches with the Office of the Commissioner of Insurance in accordance with s. 611.54(1) (a), Wis. Stat.

3. Page 21 - Agents—It is recommended that the company submit an application with the Office of the Commissioner of Insurance for all the company's agent appointments in accordance with s. 628.11, Wis. Stat.

4. Page 21 - Agents—It is recommended that the company obtain and retain a copy of all their agents' current Errors & Omissions documentation on an annual basis to provide assurance that company agents have adequate E&O coverage.

5. Page 21 - Agents—It is recommended that the company utilized their system generated loss ratio reports, by agent, to aid in evaluating an agent's performance.

6. Page 22 - Accounts and Records—It is recommended that the company properly segregate the duties of signing checks and handling cash from those of performing accounting functions and reconciling month-end bank balances in accordance with s. Ins 13.05 (4), Wis. Adm. Code.

7. Page 23 - Accounts and Records—It is recommended that the company discontinues the practice of pre-signing blank checks.

8. Page 23 - EDP Environment—It is recommended that the company retain its year-end backed-up data for all years since the last OCI examination, pursuant to s. Ins 6.80, Wis. Adm. Code.

9. Page 23 - EDP Environment—It is recommended that the company develop or obtain manuals documenting the use of its software applications and document its computer system technology.

10. Page 24 - Disaster Recovery Plan—It is again recommended that the company develop a written disaster recovery plan.

11. Page 27 - Stock and Mutual Fund Investments—It is recommended that the company divest of the Fidelity Advisors Mid-Cap Mutual Fund to be in compliance with s. Ins 6.20 (6) (c), Wis. Adm. Code

12. Page 27 - Stock and Mutual Fund Investments— It is recommended, pursuant to 6.20(6)(c), Wis. Adm. Code, that the company refrain from investing in any type 2 assets, including reinvesting any proceeds produced from its type 2 investments until the company has sufficient type 1 assets.

13. Page 27 - Stock and Mutual Fund Investments— It is again recommended that the company divest a portion of its investment in a family of mutual funds to be under the 10% limit of admitted assets in compliance with s. Ins 6.20 (6) (d) 3. c, Wis. Adm. Code.

14. Page 27 - Stock and Mutual Fund Investments—It is again recommended that the company adopt and file a written investment plan with the Office of the Commissioner of Insurance in accordance with s. Ins 6.20 (6) (h) 1, Wis. Adm. Code.

15. Page 28 - Book Value of Real Estate—It is recommended that in the future the company request prior approval from the Office of the Commissioner of Insurance to purchase realty property in compliance with s. Ins 6.20 (6) (d) 6, Wis. Adm. Code.

16. Page 28 - Deferred Premium—It is recommended that the company report premiums in the Course of Collection, Deferred Premiums, and Advanced Premiums as separate line items in the Annual Statement in accordance with Annual Statement Instructions.

17. Page 28 - Deferred Premium—It is recommended that the company non-admit all premiums receivable balances that are 90-days past due in accordance with the Annual Statement Instructions.

18. Page 29 - Investment Income Due and Accrued—It is recommended that the company correctly calculate the investment income due and accrued in accordance with Annual Statement Instructions.

19. Page 30 - Unpaid Loss Adjustment Expense—It is recommended that the company uses the paid-to-paid methodology or develop its own calculation to establish an adequate reserve for loss adjustment expenses.

VII. ACKNOWLEDGMENT

The courteous cooperation extended to the examiners by the company's personnel is hereby acknowledged.

In addition to the undersigned, Christine Shan of the Office of the Commissioner of Insurance, State of Wisconsin, participated in the examination:

Respectfully submitted,

John Litweiler
Examiner-in-Charge